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Legislative Audit Division

State of Montana

Report to the Legislature

November 2003

Financial Audit

For the Fiscal Year Ended June 30, 2003

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Montana State Fund

A Component Unit of the State of Montana

This is our annual financial audit report on the Montana State Fund for the fiscal year ending June 30, 2003. The objectives of our financial audit included determining if the Montana State Fund's financial statements presented fairly its financial position and results of operations at and for the period ending June 30, 2003, with comparative totals at and for the period ending June 30, 2002.

This report contains no recommendations.

Direct comments/inquiries to:
Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

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FINANCIAL AUDITS

Financial audits are conducted by the Legislative Audit Division to determine if the financial statements included in this report are presented fairly and the agency has complied with laws and regulations having a direct and material effect on the financial statements. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States General Accounting Office. Financial audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) certificates.

Government Auditing Standards, the Single Audit Act Amendments of 1996 and OMB Circular A-133 require the auditor to issue certain financial, internal control, and compliance reports. This individual agency audit report is not intended to comply with these requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2003, will be issued by March 31, 2004. The Single Audit Report for the two fiscal years ended June 30, 2001, was issued on March 26, 2002. Copies of the Single Audit Report can be obtained by contacting:

Single Audit Coordinator
Office of Budget and Program Planning
State Capitol
Helena MT 59620
Phone (406) 444-3616

Legislative Audit Division
Room 160, State Capitol
PO Box 201705
Helena MT 59620-1705

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John W. Northey, Legal Counsel

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

November 2003

The Legislative Audit Committee
of the Montana State Legislature:

This is our report on the financial audit of the Montana State Fund, a component unit of the State of Montana, for the fiscal year ended June 30, 2003. The objectives of this audit include determining if the financial statements for fiscal year 2002-03, with comparative financial amounts for fiscal year 2001-02, present fairly the Montana State Fund's financial position at June 30 for each fiscal year and the results of its operation for the two fiscal years then ended. We tested compliance with laws that have a direct and material effect on the financial statements.

This report also includes Management's Discussion and Analysis. This is supplementary information required by the Governmental Accounting Standards Board. As disclosed in the Independent Auditor's Report, we did not audit the information and express no opinion on it.

Montana State Fund is a workers' compensation insurance company established by the state of Montana. It is a nonprofit, quasi-public entity that provides Montana employers with an option for workers' compensation and occupational disease insurance. Montana State Fund is governed by a seven-member board of directors appointed by the Governor. State law separates funding sources for claims incurred before July 1, 1990 (Old Fund) and those incurred on or after July 1, 1990 (New Fund).

Montana State Fund management must set premium rates at amounts sufficient, when invested, to carry the estimated cost of all claims to maturity, to meet the reasonable expenses of conducting the business of the New Fund, and to maintain an excess of surplus over the amount produced by the National Association of Insurance Commissioners' risk-based capital requirements for a casualty insurer. The Old Fund costs are currently funded by investment earnings. The investments of the Montana State Fund are managed by the Montana Board of Investments and invested according to policies established in law. The prior audit report included no recommendations to Montana State Fund.

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On page A-1, you will find the Independent Auditor's Report followed by the Management Discussion and Analysis, the financial statements and accompanying notes. We issued an unqualified opinion which means the reader can rely on the presented information. Montana State Fund's response to our audit is on page B-1.

We thank the Montana State Fund staff for their cooperation and assistance during the audit.

Respectfully submitted,

Scott A. Seacat
Legislative Auditor

Appointed and Administrative Officials

Montana State Fund	Laurence Hubbard	President/CEO
	Mark Barry	Vice President, Corporate Support
	Layne Kertamus	Vice President, Insurance Operations
	Peter Strauss	Vice President, Insurance Operations Support
	Nancy Butler	General Counsel

State Fund Board of Directors

	Term Expires
Herb Leuprecht	2005
Ed Henrich	2007
Mardi Madsen	2007
Derek Scoble	2007
Derek Grewatz	2005
Jack Morgenstern	2005
Mark Cole	2005

For additional information concerning the Montana State Fund, contact Laurence Hubbard, President/CEO, at:

5 South Last Chance Gulch
Helena MT 59601
(406) 444-6501

Members of the audit staff involved in this audit were Geri Hoffman, Alexa O'Dell, Sonia Powell, and Jennifer Solem.

LEGISLATIVE AUDIT DIVISION

Scott A. Seacat, Legislative Auditor
John W. Northey, Legal Counsel

Deputy Legislative Auditors:
Jim Pellegrini, Performance Audit
Tori Hunthausen, IS Audit & Operations
James Gillett, Financial-Compliance Audit

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee
of the Montana State Legislature:

We have audited the accompanying Statements of Net Assets, New Fund and Old Fund, of the Montana State Fund, a component unit of the state of Montana, as of June 30, 2003 and 2002, and the related Statements of Revenues, Expenses, and Changes in Fund Net Assets, New Fund and Old Fund, and the Statements of Cash Flows, New Fund and Old Fund, for the fiscal years then ended. The information contained in these financial statements is the responsibility of the Montana State Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Fund as of June 30, 2003 and 2002, and the results of its operations and its cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management Discussion and Analysis is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Respectfully submitted,

James Gillett, CPA
Deputy Legislative Auditor

November 3, 2003

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Montana State Fund's Management Discussion and Analysis, Financial Statements and Notes

Montana State Fund
(A Component Unit of the State of Montana)
Management Discussion and Analysis
June 30, 2003 and 2002

Description of Business

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to as the New Fund, or MSF.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax . No State general fund money is used for MSF operations.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

Financial Position – MSF (New Fund)

MSF's financial position weakened from fiscal year 2002 to 2003. Total net assets decreased from $180,715,283 in 2002 to $163,093,815 in 2003, a reduction of 9.8%. This reduction is primarily due to the impact of the $67,000,000 change in estimated claims payable, an increase in the total liability of 19.3% from 2002 to 2003, due to adverse development on prior year losses. Contributing to the reduction in net assets are increases in benefit payments and operating expenses. The reduction however, is partially offset by premium growth of 26.7%. Total net earned premium in 2003 is $117,776,580, up from $92,971,868 in 2002. The following discussion will explain the reasons for these changes and provide additional background to MSF's financial position.

Assets

During fiscal year 2003, MSF continued its investment strategy by purchasing both bonds and equity securities. In 2003, the book value of equity securities increased to $79,000,000 from $74,000,000 in 2002. In 2003 the equity security carrying value, which includes a $9,041,847 unrealized loss, is $69,958,153, or 12.2% of MSF's total cash and investments. In 2002 equity securities' carrying value, which includes a $9,819,361 unrealized loss, is $64,180,639 which is 12.4% of MSF's total cash and investments. Total bonds in 2003 have grown to $472,365,241 up from $431,973,898 in 2002. This results in a bond to total cash and investment ratio of 82.2% in 2003 compared to 83.4% in 2002. All investments are considered long term. Cash and cash equivalents are classified as current assets and increased from $22,034,874 in 2002 to $32,140,643 in 2003. Most of this increase is attributed to an increase in MSF's portion of the short-term investment pool (STIP).

Net premiums receivable, at $4,164,418 in 2003, decreased slightly from prior year's net premiums receivable of $4,426,378. Net receivables are expected to be collectible within one year. Other receivables for fiscal year 2003 consist of interest receivables of $6,586,054 and notes receivable of $198,589 of which $73,341 is long term. Other receivables for fiscal year 2002 consist of interest receivables of $6,441,102 and notes receivable of $223,047, of which $51,910 is long term.

Equipment decreased slightly from the prior year with fiscal year 2003 acquisitions of $566,410 offset by retirements of $690,572. Acquisitions consist primarily of information technology equipment, which also comprises approximately half of the retirements, with vehicles and furniture making up the remaining half. This compares to fiscal year 2002 acquisitions of $550,214 offset by retirements of $221,368. Accumulated depreciation decreased $56,939 from year to year due to fiscal year 2003 depreciation expense of $533,367 and allocated depreciation expense of $12,976 to Old Fund offset by retirements of $603,282. Depreciation expense in fiscal year 2002 totaled $567,676 with the Old Fund allocation of $70,381 offset by retirements of $191,947.

In fiscal year 2003 intangible assets decreased to $2,110,370 from $3,097,837 in 2002. Fiscal year 2003 acquisitions are $205,617 offset by amortization expense of $1,072,431 and allocated amortization expense of $120,653 to the Old Fund. Amortization expense in 2003 decreased $2,018,685, or 65.3%, from 2002 due to an accounting change reducing the useful life of intangible assets from seven to five years. This accounting change resulted in additional amortization expense of $1,996,833 in 2002.

Under the provisions of the state constitution, MSF's invested assets are managed by the Montana Board of Investments (BOI). The BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank to lend MSF's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. State Street Bank was appointed the BOI's custodial bank on December 1, 1993. During the period the securities are on loan, BOI receives a fee and the bank must initially receive collateral equal to 102% of the market value of the securities on loan and must maintain

collateral equal to not less than 100% of the market value of the loaned security. BOI retains all rights of ownership during the loan period. The total collateral held at the end of fiscal year 2003 is $30,968,721 compared to $57,563,169 in 2002, all of which is classified as a short-term asset with an offsetting short-term liability.

Other assets are comprised of prepaid expenses and other advances, property held in trust and deferred acquisition costs. Other assets increased to $2,347,602 in 2003 from $1,672,554 in 2002, primarily due to an increase in deferred acquisition costs, attributable to increased commissions and increased written premium in 2003 over 2002.

Liabilities

Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2003 and June 30, 2002. Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2003 and 2002. The estimated claims payable is presented undiscounted, net of estimated reinsurance recoverable, at $413,400,000 and $346,400,000, as of June 30, 2003 and June 30, 2002, respectively.

The estimated claims payable increased $67,000,000 from 2002 to 2003 primarily due to adverse loss development of approximately $36,450,000 on prior year claims. MSF currently has no knowledge of any significant environmental or asbestos claims that would contribute to this estimate. The short-term portions of the estimated claims payable are $87,603,000 and $71,934,000 for fiscal years 2003 and 2002, respectively. The long-term portions of the payable are $325,797,000 and $274,466,000 for fiscal years 2003 and 2002, respectively.

Property held in trust increased to $4,498,097 in 2003, up from $2,140,866 in 2002 due to the funds withheld account requirement of MSF's aggregate stop loss reinsurance treaty. The three-year treaty, effective July 1, 2002, includes a provision for MSF to maintain a funds withheld account in the amount of $2,150,000 for fiscal year 2003 with interest accruing at 6.5%, totaling $143,193 at June 30, 2003. In fiscal year 2002, MSF's aggregate stop loss reinsurance treaty was commuted and the funds withheld account was reversed, leaving a zero balance at June 30, 2002.

Deferred revenue decreased to $202,912 in 2003 from $583,980 in 2002 due to fewer policy billings at fiscal year end. The entire balance is classified as short-term since the billings are for one year or less.

As discussed above in the *Assets* section, the BOI has a Securities Lending Authorization Agreement to lend MSF's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. The total collateral owed at the end of fiscal year 2003 is $30,968,721 compared to $57,563,169 in 2002, all of which is classified as a short-term liability with an offsetting short-term asset.

Other MSF payables consist of accounts payable and payables for leases and compensated absences. Accounts payable experienced the greatest change from prior year and increased to $6,959,896 at June 30, 2003, up from $3,722,538 at June 30, 2002. This increase is attributable to end of year accruals of additional benefits and commissions.

Net Assets

During fiscal year 2003, net assets decreased from $180,715,283 in 2002 to $163,093,815 in 2003 due to a net loss of $17,621,468. Net assets are restricted by the sum of capital assets which amount to $2,764,403 in 2003 compared to $3,997,573 in 2002.

Results of Operations – MSF (New Fund)

Net Premiums Earned

Net premiums earned in fiscal year 2003 totaled $117,776,580, up from $92,971,868 in 2002, a 26.7% increase. The increase is driven by a significant number of new policies. MSF writes other states coverage for Montana state-domiciled insureds that have locations in states other than Montana. Other states coverage premium revenue remained consistent with the prior year.

Investment-Related Revenue

In fiscal year 2003, investment revenue increased by $19,358,957 or 72.2% over fiscal year 2002. The reason for this increase is the change in unrealized gains and losses on bonds from year to year. In fiscal year 2003 there is an unrealized gain of $19,312,732 compared to an unrealized loss of $2,106,803 in fiscal year 2002. Realized investment income in 2003 decreased by $2,114,220 from 2002. A portion of this decrease is due to the additional purchase of equity investments during fiscal year 2003, as no investment income is earned on equity securities. However, most of this decrease is due to lower rates of return in 2003 compared to 2002. Also included in investment income are administrative costs to BOI of $152,852 in 2003 and $153,900 in 2002. The fiscal year 2003 amortization of bond premium and accretion of bond discounts are $568,706 and $384,206, respectively, and are $505,152 and $418,072, respectively, for fiscal year 2002. Other investment income of $150,021 was recognized in 2003 and represents consent fees on the bonds sold during the year.

Net realized gains decreased to $3,112,888 in 2003, down from $6,569,675 in 2002 primarily due to the sales of treasury bonds and treasury notes during the second and third quarters of fiscal year 2002. Net realized losses decreased to $986,736 in 2003, down from $2,218,050 in 2002, primarily due to the $2,010,000 permanent write down of Enron bonds in fiscal year 2002. Securities lending income decreased to $750,925 in 2003 from $2,081,848 in 2002. The associated expense also decreased to $673,628 in 2003 from $1,853,474 in 2002.

Other Nonoperating Revenue and Expenses

In fiscal year 2003, MSF received $97,724 in royalty income for the sale of in-house developed software compared to $230,632 in 2002. In 2002, other income resulted from the reversal of $123,213 in reinsurance funds withheld interest due to the commutation of MSF's aggregate stop loss reinsurance treaty. The *Liabilities* section above discusses the reinsurance treaties, the required funds withheld accounts and the 2002 commutation.

Other transactions impacting surplus include dividends paid to policyholders which totaled $2,949,597 in 2003 and $4,001,224 in 2002. In fiscal year 2002, $7,407,512 was transferred from the Old Fund to the New Fund, but in fiscal year 2003, the transfer was made to the State of Montana rather than to the New Fund. House Bill Number 363, enacted by the 2003 Montana Legislature, changes existing law regulating the Old Fund transfer of surplus, including changing the recipient of the transfer from New Fund to the General Fund. For additional discussion on the transfer, see *Other Nonoperating Revenue and Expenses* in the *Results of Operations – Old Fund* section.

Operating Expenses

Benefits paid in 2003 are $151,964,040 compared to $89,730,999 in 2002, resulting in an increase of $62,233,040. The increase is driven primarily by the change in the estimated claims liability, which increased due to adverse loss development on prior year losses. In 2003, the estimated claims liability increased by $67,000,000 compared to $20,500,000 in 2002 and is discussed in more detail in the *Liabilities* section above. In addition, both medical and indemnity costs increased in 2003 over 2002. Medical payments increased 26.8% and indemnity payments increased 17.5%.

Personal services increased from $12,741,259 in 2002 to $13,828,981 in 2003, an 8.5% increase. Contractual services increased $2,000,318 in fiscal year 2003 due to increased commission payments on higher premium levels. Supplies and materials increased to $1,058,390 in fiscal year 2003 due to purchases of minor equipment and software.

Depreciation expense for fiscal year 2003 decreased $34,309 from fiscal year 2002 and amortization expense for fiscal year 2003 decreased $2,018,685 from fiscal year 2002. The decreases are due to an accounting change recorded in fiscal year 2002 for the change in useful life of computer equipment and intangible assets. See *Assets* discussion above for further explanation.

Other operating expenses increased to $1,429,604 in 2003 from $681,746 in 2002, a change of $747,856. Approximately 32% of this change is due to increased bad debt expense and 46% due to increased job candidate expense. Other operating expenses for 2003 also include funds withheld interest of $143,193.

Change in Net Assets

The change in net assets for fiscal year 2003 is ($17,621,468) compared to $11,732,599 in fiscal year 2002, a decrease of $29,354,067. Although premium levels increased, it is insufficient to cover the increased benefit payments and adverse loss development of prior year losses. Although investment income increased due to the unrealized gain on bonds, MSF did not receive the transfer from Old Fund as was the case in fiscal year 2002.

Financial Position – Old Fund

Old Fund's financial position has weakened from fiscal year 2002 to 2003. Old Fund's primary source of income is investment income that helps to maintain adequate reserve levels to fund claims dated prior to July 1, 1990. Fiscal year 2003 experienced slightly lower investment income plus higher benefit payments. In addition, a change in law increased the transfer amount of Old Fund's excess surplus. The following discussion will provide additional background to Old Fund's financial position.

Assets

Old Fund's investment portfolio consists of long-term bonds which decreased to $81,902,359 in fiscal year 2003 from $109,351,626 in fiscal year 2002. The bond to total cash and investment ratio for 2003 is 94.5% compared to 95.3% for 2002. As reserve levels decrease and funds are transferred out of Old Fund, monies to be invested decrease. For further explanation, see the estimated claims payable and transfer discussions below in the *Liabilities* and *Other Nonoperating Revenue and Expenses* sections.

Interest receivable for the year ended June 30, 2003 is $1,183,329 compared to $1,637,653 for year ended June 30, 2002. Net accounts receivable consists of medical overpayments and remaining receivables from the Old Fund Liability Tax. Net accounts receivable for 2003 is $98,514, down from $794,586 in 2002. The decrease from fiscal year 2002 to 2003 is due to an adjustment, requested by the Department of Administration, for transactions recorded by the Department of Revenue to the Old Fund Liability Tax accounts.

Old Fund is also a part of the BOI's Securities Lending Authorization Agreement and therefore has securities lending collateral with an offsetting securities lending liability at year end. The balance for 2003 is $6,099,450 and the balance for 2002 is $16,600,000.

Liabilities

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2003 and June 30, 2002, is used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled and claims that have been incurred, but not reported (IBNR). Tillinghast-Towers Perrin provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of

unpaid claims and claim adjustment expenses, for fiscal years 2003 and 2002. As of June 30, 2003, the undiscounted estimated claims payable is $113,180,563 and is presented at net present value of $80,900,000 discounted at a 5.25% rate. As of June 30, 2002, the undiscounted estimated claims payable is $128,902,238 and is presented at net present value of $90,900,000 discounted at a 5.50% rate. The decrease in the discount rate from 2002 to 2003 is due to lower investment rates of return and lower investment levels from year to year.

Reserve levels will continue to decrease with time, since Old Fund has no new claims but continues to pay on already-existing claims. As reserve levels decrease, so will the need to fund those levels resulting in decreasing investment needs over time. This trend is evident with the lower 2003 estimated claims payable and investment balances when compared to 2002. The short-term portions of the estimated claims payable are $10,178,000 and $11,708,000 for fiscal years 2003 and 2002, respectively. The long-term portions of the payable are $70,722,000 and $79,192,000 for fiscal years 2003 and 2002, respectively.

Net Assets

During fiscal year 2003, total net assets decreased from $24,866,024 in 2002 to $6,194,791 in 2003 due to a net loss of $18,591,337 and a prior period adjustment of $79,896. The prior period adjustment is the result of the Old Fund Liability Tax adjustment requested by the Department of Administration as described above in the *Assets* section. Net assets are restricted by the estimated amount of the next fiscal year's transfer to the State of Montana, General Fund. The estimated transfer amount for 2003 is $815,605 compared to $13,177,907 in 2002.

Results of Operations – Old Fund

Investment-Related Revenue

Investment income is $8,857,998 in fiscal year 2003, down from $9,576,467 in fiscal year 2002. The decrease is due to a lower interest income from bonds offset by an unrealized gain on investments. In fiscal year 2003 the unrealized gain is $3,418,290 compared to an unrealized gain of $2,598,117 in fiscal year 2002.

Other Nonoperating Revenue and Expenses

Section 39-71-2352 (5), MCA provided for the payment of excess funds from the Old Fund to MSF based on adequate funding levels in the Old Fund. This applied to the transfer of $7,407,512 to New Fund in fiscal year 2002.

House Bill Number 363 (HB 363) was enacted by the 2003 Montana Legislature and changed the existing law regulating the Old Fund transfer of surplus. HB 363 removes the 10% reserve requirement for the Old Fund and transfers the reserve as well as any remaining available funds from Old Fund to the General Fund, rather than to MSF. In fiscal year 2003, $22,267,907 was transferred from Old Fund to the State of Montana.

Operating Expenses

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1,250,000 for both fiscal years 2003 and 2002. MSF allocated $1,250,000 in administration costs to the Old Fund in fiscal years 2003 and 2002. The Old Fund has a $1,075,781 obligation to MSF in unrecovered administrative costs incurred in fiscal years 2003 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1,250,000.

Change in Net Assets

The change in net assets for fiscal year 2003 is a reduction of $18,591,337 compared to an increase of $2,084,459 in fiscal year 2002, resulting in an overall decrease of $20,675,796. The primary reason for this decrease is the increased transfer of excess surplus (see related discussion in *Other Nonoperating Revenue and Expenses* above) as well as increased benefit payments.

MONTANA STATE FUND - NEW FUND
STATEMENT OF NET ASSETS
Montana State Fund is a component unit of the State of Montana

JUNE 30,	2003	2002
ASSETS		
Current Assets		
Cash and cash equivalents	32,140,643	22,034,874
Receivables, net	10,875,720	11,038,617
Due from primary government	1,597	654,216
Due from component units	185,117	519,294
Securities lending collateral	30,968,721	57,563,169
Other assets	2,347,602	1,672,554
Total Current Assets	76,519,400	93,482,724
Noncurrent Assets		
Investments	542,323,394	496,154,537
Notes and loans receivable	73,341	51,910
Equipment	2,970,105	3,094,267
Accumulated depreciation	(1,846,144)	(1,903,083)
Intangible assets	2,110,370	3,097,837
Total Noncurrent Assets	545,631,066	500,495,468
Total Assets	622,150,466	593,978,192
LIABILITIES		
Current Liabilities		
Accounts payable	6,959,896	3,722,538
Due to primary government	1,139,171	1,291,120
Estimated claims payable	87,603,000	71,934,000
Compensated absences	723,043	814,643
Lease payable	161,127	68,109
Securities lending liability	30,968,721	57,563,169
Deferred revenue	202,912	583,980
Property held in trust	4,498,097	2,140,866
Total Current Liabilities	132,255,967	138,118,425
Noncurrent Liabilities		
Estimated claims payable	325,797,000	274,466,000
Compensated absences	694,883	455,145
Lease payable	308,801	223,339
Total Noncurrent Liabilities	326,800,684	275,144,484
Total Liabilities	459,056,651	413,262,909
NET ASSETS		
Invested in capital assets, net of related debt	2,764,403	3,997,573
Unrestricted	160,329,412	176,717,710
Total Net Assets	163,093,815	180,715,283
Total Liabilities and Net Assets	622,150,466	593,978,192

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - NEW FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2003	2002
Net premiums earned	117,776,580	92,971,868
Operating Expenses		
Benefits and claims	151,964,040	89,730,999
Personal services	13,828,981	12,741,259
Contractual services	9,137,989	7,137,672
Supplies and materials	1,058,390	595,949
Depreciation	533,367	567,676
Amortization	1,072,431	3,091,116
Rent and utilities	212,547	198,910
Communications	938,603	936,777
Travel	208,188	220,737
Repair and maintenance	518,276	487,605
Interest expense	18,758	14,653
Other operating expenses	1,429,604	681,746
Total Operating Expenses	180,921,174	116,405,099
Operating Loss	(63,144,594)	(23,433,231)
Nonoperating Revenue (Expenses)		
Investment income	46,166,631	26,807,673
Gains on investments	3,112,888	6,569,675
Securities lending income	750,925	2,081,848
Losses on investments	(986,736)	(2,218,050)
Securities lending expense	(673,628)	(1,853,474)
Royalties	97,724	230,632
Penalties and interest	29,846	23,206
Payment from Old Fund	-	7,407,512
Payment to State of Montana	(1,288)	(25,000)
Loss on retirement of assets	(56,057)	(14,140)
Dividend expense	(2,949,597)	(4,001,224)
Other income	32,418	157,172
Total Nonoperating Revenue	45,523,126	35,165,830
Change in Net Assets	(17,621,468)	11,732,599
Total Net Assets - Beginning	180,715,283	168,982,684
Total Net Assets - Ending	163,093,815	180,715,283

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - NEW FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts for premiums	120,604,417	88,132,388
Payments to suppliers for goods and services	(13,171,804)	(10,558,640)
Payments to employees	(13,856,547)	(12,101,680)
Cash payments for claims	(82,147,587)	(69,167,607)
Other operating receipts	164,507	406,491
Other operating payments	(2,949,597)	(4,001,224)
Net Cash Provided by (Used for) Operating Activities	8,643,389	(7,290,272)
CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES		
Payment from Old Fund	-	7,407,512
Payment to State of Montana	(818)	(25,000)
Net Cash Provided by (Used for) Noncapital Financing Activities	(818)	7,382,512
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition of fixed assets	(571,838)	(599,961)
Proceeds from sale of fixed assets	20,436	15,280
Net Cash Used for Capital and Related Financing Activities	(551,402)	(584,681)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(229,438,861)	(210,937,837)
Proceeds from sales or maturities of investments	202,398,236	168,349,006
Proceeds from securities lending transactions	750,925	2,081,848
Payments of security lending costs	(716,597)	(2,082,634)
Interest and dividends on investments	29,020,897	34,087,473
Net Cash Provided by (Used For) Investing Activities	2,014,600	(8,502,144)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	10,105,769	(8,994,585)
CASH AND CASH EQUIVALENTS - JULY 1	22,034,874	31,029,459
CASH AND CASH EQUIVALENTS - JUNE 30	32,140,643	22,034,874

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - NEW FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2003	2002
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH PROVIDED BY (USED FOR) OPERATING ACTIVITIES		
Change in Net Assets	(17,621,468)	11,732,599
Adjustments to Reconcile Change in Net Assets to Net Cash Provided by (Used for) Operating Activities		
Depreciation	533,367	567,676
Amortization	1,072,431	3,091,116
Interest expense	18,758	14,653
Security lending costs	673,628	1,853,474
Security lending income	(750,925)	(2,081,848)
Interest on investment	(48,292,783)	(31,159,298)
Payment from Old Fund	-	(7,407,512)
Payment to State of Montana	1,288	25,000
Decrease (increase) in		
Accounts receivable	307,849	13,169,128
Due from component units	986,796	251,666
Notes receivable	(21,431)	(51,910)
Other assets	(618,991)	(972,601)
Increase (decrease) in		
Accounts payable	3,205,805	1,450,928
Due to primary government	(153,716)	175,049
Deferred revenue	(381,068)	(15,573,363)
Property held in trust	2,357,231	(3,240,484)
Estimated claims	67,000,000	20,500,000
Lease payable	178,480	256,951
Compensated absences	148,138	108,504
Total adjustments	26,264,857	(19,022,871)
Net Cash Provided by (Used for) Operating Activities	8,643,389	(7,290,272)

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF NET ASSETS
Montana State Fund is a component unit of the State of Montana

JUNE 30,	2003	2002
ASSETS		
Current Assets		
Cash and cash equivalents	4,743,496	5,405,674
Receivables, net	1,281,843	2,432,239
Due from primary government	-	730
Securities lending collateral	6,099,450	16,600,000
Total Current Assets	12,124,789	24,438,643
Noncurrent Assets		
Investments	81,902,359	109,351,626
Total Assets	94,027,148	133,790,269
LIABILITIES		
Current Liabilities		
Accounts payable	582,675	230,884
Due to primary government	1,889	-
Due to component units	185,117	519,294
Estimated claims payable	10,178,000	11,708,000
Compensated absences	63,226	-
Deferred revenue	-	610,841
Securities lending liability	6,099,450	16,600,000
Total Current Liabilities	17,110,357	29,669,019
Noncurrent Liabilities		
Estimated claims payable	70,722,000	79,192,000
Compensated absences	-	63,226
Total Noncurrent Liabilities	70,722,000	79,255,226
Total Liabilities	87,832,357	108,924,245
NET ASSETS		
Restricted	815,605	13,177,907
Unrestricted	5,379,186	11,688,117
Total Net Assets	6,194,791	24,866,024
Total Liabilities and Net Assets	94,027,148	133,790,269

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF REVENUES, EXPENSES, and CHANGES IN FUND NET ASSETS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2003	2002
Operating Expenses		
Benefits and claims	4,273,383	(916,420)
Personal services	-	11,969
Contractual services	1,078,828	1,005,110
Depreciation	12,976	70,381
Amortization	120,653	105,928
Other operating expenses	301,211	349,452
Total Operating Expenses	5,787,051	626,420
Operating Loss	(5,787,051)	(626,420)
Nonoperating Revenue (Expenses)		
Investment income	8,857,998	9,576,467
Gains on investments	632,698	568,925
Securities lending income	187,399	235,108
Losses on investments	(47,840)	(85,805)
Securities lending expense	(167,089)	(204,500)
Payment to State of Montana	(22,267,907)	-
Payment to New Fund	-	(7,407,512)
Liability tax	455	28,196
Total Nonoperating Revenue (Expenses)	(12,804,286)	2,710,879
Change in Net Assets	(18,591,337)	2,084,459
Total Net Assets - Beginning	24,866,024	22,781,565
Prior Period Adjustment	(79,896)	-
Total Net Assets - Ending	6,194,791	24,866,024

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES		
Payments to suppliers for goods and services	(1,845,955)	(1,856,487)
Payments to employees	-	(11,969)
Cash payments for claims	(13,897,538)	(12,732,709)
Collection of payroll taxes	1,184	26,529
Net Cash Used for Operating Activities	(15,742,309)	(14,574,636)
CASH FLOWS FROM NONCAPITAL FINANCIAL ACTIVITIES		
Payment to State of Montana	(22,267,907)	-
Payment to New Fund	-	(7,407,512)
Net Cash Used for Noncapital Financing Activities	(22,267,907)	(7,407,512)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(6,397,094)	(27,262,989)
Proceeds from sales or maturities of investments	37,214,538	36,907,532
Proceeds from securities lending transactions	187,399	235,108
Payments of security lending costs	(185,807)	(190,064)
Interest and dividends on investments	6,529,002	7,233,710
Net Cash Provided by Investing Activities	37,348,038	16,923,297
NET DECREASE IN CASH AND CASH EQUIVALENTS	(662,178)	(5,058,851)
CASH AND CASH EQUIVALENTS - JULY 1	5,405,674	10,464,525
CASH AND CASH EQUIVALENTS - JUNE 30	4,743,496	5,405,674

The notes to the financial statements are an integral part of this statement.

MONTANA STATE FUND - OLD FUND
STATEMENT OF CASH FLOWS
Montana State Fund is a component unit of the State of Montana

YEARS ENDED JUNE 30,	2003	2002
RECONCILIATION OF CHANGE IN NET ASSETS TO NET CASH USED FOR OPERATING ACTIVITIES		
Change in Net Assets	(18,591,337)	2,084,459
Adjustments to Reconcile Change in Net Assets to Net Cash Used for Operating Activities		
Security lending costs	167,089	204,500
Security lending income	(187,399)	(235,108)
Interest on investment	(9,442,855)	(10,059,587)
Payment to State of Montana	22,267,907	-
Payment to New Fund	-	7,407,512
Prior period adjustment for payroll taxes	(79,896)	
Decrease (increase) in		
Accounts receivable	696,072	(21,341)
Due from primary government	730	389
Increase (decrease) in		
Accounts payable	370,508	166,433
Due to component units	(332,288)	(327,003)
Deferred revenue	(610,840)	5,110
Estimated claims	(10,000,000)	(13,800,000)
Total adjustments	2,849,028	(16,659,095)
Net Cash Used for Operating Activities	(15,742,309)	(14,574,636)

The notes to the financial statements are an integral part of this statement.

1. Summary of Significant Accounting Policies

Description of Business

The Montana State Fund (MSF) is a nonprofit, quasi-public entity established under Title 39, chapter 71 of the Montana Code Annotated (MCA). MSF provides Montana employers with an option for workers' compensation and occupational disease insurance and guarantees available coverage for all employers in Montana. MSF is governed by a seven member Board of Directors appointed by the Governor. MSF is attached to the State of Montana, Department of Administration for administrative purposes only.

During the 1990 Montana Special Legislative Session, legislation passed establishing separate funding and accounts for claims of injuries resulting from accidents occurring before July 1, 1990, referred to as the Old Fund, and claims occurring on or after July 1, 1990, referred to MSF.

MSF functions as an autonomous insurance entity supported solely from its own revenues. All assets, debts, and obligations of MSF are separate and distinct from assets, debts, and obligations of the State of Montana. If MSF is dissolved by an act of law, the money in MSF is subject to the disposition provided by the legislature enacting the dissolution with due regard given to obligations incurred and existing (Section 39-71-2322, MCA). MSF administers and manages the claims remaining in the Old Fund for the State of Montana and is the administering entity for recording the financial activity related to receipt and disbursement of an Old Fund Liability Tax (see Note 4). No State general fund money is used for MSF operations.

MSF financial statements are presented as a component unit in the State of Montana Comprehensive Annual Financial Report. The fiscal year 2003 and 2002 financial statements are presented in conformance with GASB 34 which is a comparable format to the State of Montana Comprehensive Annual Financial Report. Fiscal year 2002 financial statements have been restated to comply with state policy issued during fiscal year 2003. This policy relates to the implementation of GASB 34.

Basis of Accounting

MSF uses the accrual basis of accounting, as defined by generally accepted accounting principles, for its workers' compensation insurance operations. Under the accrual basis, MSF records revenues in the accounting period earned, if measurable, and records expenses in the period incurred, if measurable.

Cash and Cash Equivalents

Cash balances include demand deposits with the State Treasury. MSF also participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid

investments with maturities of 397 days or less with the exception of securities having rate reset dates. There are no legal risks that the Montana Board of Investments (BOI) is aware of regarding any STIP investments. The STIP portfolio is carried at amortized cost or book value with market value approximating cost. MSF's STIP balance of $29,965,376 as of June 30, 2003 represents 2.11% of the total STIP. The Old Fund STIP balance of $4,738,975 as of June 30, 2003 represents 0.33% of the total STIP. MSF's STIP balance of $20,909,313 as of June 30, 2002 represents 1.39% of the total STIP. The Old Fund STIP balance of $5,192,060 as of June 30, 2002 represents 0.35% of the total STIP.

The STIP investments' credit risk is measured by investment grade ratings given individual securities. The BOI's policy requires that STIP investments have the highest rating in the short-term category by one and/or any Nationally Recognized Statistical Rating Organizations (NRSRO). The four NRSRO's include Standard and Poor's, Moody's Investors Service, Fitch, Inc. and Dominion Bond Rating Service Ltd.

Asset-backed securities constitute 51.63% of the BOI's total STIP portfolio as of June 30, 2003. Asset-backed securities have less credit risk than do securities not backed by pledged assets. Market risk for asset-backed securities is the same as market risk for similar non asset-backed securities. Asset-backed securities constitute 60.75% of the Board of Investment's total STIP portfolio as of June 30, 2002.

Variable rate (floating rate) securities make up 44.42% of the BOI's total STIP portfolio as of June 30, 2003. Variable rate securities make up 32.71% of the BOI's total STIP portfolio as of June 30, 2002. While variable rate securities have credit risk identical to similar fixed rate securities, their market risk (income) is more sensitive to interest rate changes. However, the market risk (value/price) may be less volatile than fixed rate securities because their value will usually remain at or near par as a result of their interest rates being periodically reset to maintain a current market yield.

Investments

In addition to STIP investments, MSF invests in long-term securities with the BOI. Under the provisions of the state constitution, MSF's invested assets are managed by the BOI. Securities are stated at fair value as defined and required by Governmental Accounting Standards Board (GASB) Statement Number 31, "Accounting and Financial Reporting for Certain Investments and for External Investment Pools". Premiums and discounts are amortized using the straight-line method over the life of the securities. Net unrealized gains or losses on securities are included in net income in accordance with GASB 31.

MSF investments are classified in risk Category 1 or as Not Categorized under State of Montana standards. Risk category 1 includes investments that are insured or registered, or securities held by

the BOI or its agent in the BOI's name. Not Categorized includes investments held by broker-dealers under securities loans with cash collateral.

Under the provisions of state statutes, the BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank (SSB), to lend the BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, the BOI receives a fee and the custodial bank must initially receive collateral equal to 102% of the fair value of the securities on loan and must maintain collateral equal to not less than 100% of the fair value of the loaned security. The BOI retains all rights and risks of ownership during the loan period.

The cash collateral received on each loan was invested, together with the cash collateral of other qualified plan lenders, in a collective investment pool, the Securities Lending Quality trust. The relationship between the average maturities of the investment pool and the BOI's loans was affected by the maturities of the loans made by other plan entities that invested cash collateral in the collective investment pool, which the BOI could not determine. On June 30, 2003 and June 30, 2002, the BOI had no credit risk exposure to borrowers.

The following table presents the carrying and market values of the securities on loan and the total collateral held for fiscal years ended June 30, 2003 and June 30,2002 for both MSF and the Old Fund:

	MSF		Old Fund	
	Fiscal Year 2003	Fiscal Year 2002	Fiscal Year 2003	Fiscal Year 2002
Securities on Loan-Book Value	$26,912,989	$52,188,972	$5,511,175	$15,567,466
Securities on Loan-Market Value	$30,180,923	$55,652,152	$5,971,982	$16,022,993
Total Collateral Held	$30,968,721	$57,563,169	$6,099,450	$16,600,000

As of June 30, 2003, MSF and the Old Fund investments include $26,912,989 and $5,511,175 respectively, in long-term securities on loan that earned interest income during the fiscal year of $750,925 and $187,399 respectively.

As of June 30, 2002, MSF and the Old Fund investments include $52,188,972 and $15,567,466 respectively, in long-term securities on loan that earned interest income during the fiscal year of $2,081,848 and $235,108 respectively.

During fiscal year 2002, the BOI decreased the book value of Enron bonds by $2,010,000 for MSF. The write-down was recorded as an investment loss. There were no decreases to bond book values during fiscal year 2003.

In November 2000, the Montana Constitution was amended to allow investing in equity securities, with the restriction that equity securities cannot exceed 25% of total investment book value. However, in May 2003, the BOI approved a policy statement to keep equities in the 8% to 12% range. As of June 30, 2003, equity securities in MSF include $79,000,000 at book value, offset by $9,041,847 in market value depreciation. As of June 30, 2002, equity securities in MSF include $74,000,000 at book value, offset by $9,819,361 in market value depreciation.

Additional investment information can be found in Note 2.

Receivables

MSF's premium receivable balance is $4,633,895 at June 30, 2003 reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of $469,476. Other receivables include $6,586,053 in investment income due and $198,589 in notes and loans receivable, of which $73,341 is long term.

MSF's premium receivable balance is $4,820,854 at June 30, 2002 reduced by estimated uncollectible receivables reported as an allowance for doubtful accounts of $394,476. Other receivables include $6,441,102 in investment income due, $223,047 in notes and loans receivable, of which $51,910 is long term.

Accounts receivable in the Old Fund include amounts due from past premiums in dispute or in collection and amounts due from Old Fund Liability Tax collections. Net accounts receivable for year ended June 30, 2003 and June 30, 2002 were $98,514 and $794,586, respectively. The decrease from fiscal year 2002 to 2003 is due to an adjustment, requested by the Department of Administration, for transactions recorded by the Department of Revenue to the Old Fund Liability Tax accounts. Estimated uncollectible receivables are reported as an allowance for doubtful accounts. Interest receivable of $1,183,329 at June 30, 2003 and $1,637,653 at June 30, 2002 represents investment income due.

Equipment and Accumulated Depreciation

Equipment is capitalized if the actual or estimated historical cost exceeds $5,000. Depreciation expense is computed on a straight-line basis for equipment over a period of three to five years and amortization of intangible assets is computed on a straight-line basis over five years. Amortization of intangible assets is applied directly to the asset balance. All fixed assets are recorded in the MSF. Because MSF administers the Old Fund, the Old Fund does not carry fixed assets. During fiscal year ended June 30, 2002, the useful lives of computer equipment and intangible assets were reduced and a fiscal year 2002 adjustment made for additional depreciation expense of $245,636 and amortization expense of $1,996,833.

Other Assets

Other assets include security deposits received from certain policyholders. The deposits secure payment of premiums. Also included are deferred acquisition costs incurred during the policy writing process and that are recognized ratably over the related policy term.

Estimated Claims Payable

The estimated claims payable is established to provide for the estimated ultimate settlement cost of all claims incurred. Estimated claims payable is based on reported aggregate claim cost estimates combined with estimates for future development of such claim costs and estimates of incurred but not reported (IBNR) claims. Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study which provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimates within that range as the estimated claims payable for both MSF and Old Fund. For additional disclosure related to the estimated claims payable, refer to Note 4.

Deferred Revenue

Deferred revenue reflects amounts in advance that are received or billed, but not yet earned for policies effective July 1, 2003 or July 1, 2002.

Property Held in Trust

Property Held in Trust consists of security deposits owed to certain policyholders and the reinsurance funds withheld account, required by MSF's aggregate stop loss reinsurance contract. Additional information regarding the funds withheld account can be found in Note 3.

Net Assets

Net assets consist of the net excess or deficit of assets over liabilities. For additional information on distributions impacting total net assets see Note 6.

Premiums

The MSF Board of Directors approves premium rates annually. Generally, policies are effective for the term of the policy period not to exceed 12 months. Premium revenue is recognized over the term of the fiscal year, which runs from July 1 through June 30, as it is earned or when MSF is liable for coverage.

Policyholders are contractually obligated to pay certain premiums to MSF in advance of the period

the premiums are earned. Premium advances are refundable when the policyholder's coverage is canceled and all earned premiums have been credited by MSF.

Presentation

The financial statements are presented in accordance with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board. MSF insurance operations are classified as an enterprise fund, proprietary fund type. MSF comprises only a part of the State of Montana's enterprise funds. The financial statements in this report reflect the financial position and results of operations and cash flows of MSF and Old Fund, not the State of Montana.

An enterprise fund is used to account for operations: (a) financed and operated in a manner similar to private business enterprises, where the legislature intends that the entity finance or recover costs primarily through user charges; (b) where the legislature has decided that periodic determination of revenues earned, expenses incurred or net income is appropriate; (c) where the activity is financed solely by a pledge of the net revenues from fees and charges of the activity; (d) when laws or regulations require that the activities' costs of providing services be recovered with fees and charges rather than with taxes or similar revenues.

Investments are presented in accordance to GASB Statement Number 31, "Accounting and Financial Reporting for Certain Investments and External Investment Pools." STIP is considered an external investment pool, which is defined as an arrangement that pools the monies of more than one legally separate entity and invests, on the participant's behalf, in an investment portfolio. STIP is also classified as a "2a7-like" pool. A 2a7-like pool is an external investment pool that is not registered with the Securities and Exchange Commission (SEC) as an investment company, but has a policy that it will, and does, operate in a manner consistent with the SEC's Rule 2a7 of the Investment Company Act of 1940. If certain conditions are met, 2a7-like pools are allowed to use amortized cost rather than fair value to report net assets to compute unit values. The BOI has adopted a policy to treat STIP as a 2a7-like pool. See Note 1, Basis of Accounting – Investments and Note 2 for further discussions of the effect of GASB 31.

2. Investments

The amortized cost and market value of MSF's fixed maturity securities as of June 30, 2003, and June 30, 2002, are as follows:

June 30, 2003	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 151,604,707	$ 13,548,818	$ -	$ 165,153,525
Government Mortgage-Backed	68,051,580	2,730,889	11,093	70,771,376
Corporate Securities Asset-Backed	15,494,410	520,577	-	16,014,987
Other Corporate Securities	186,427,682	17,125,494	720,462	202,832,714
Other Securities	15,960,381	1,632,258	-	17,592,639
Equity Securities	79,000,000	-	9,041,847	69,958,153
STIP (reported as Cash & Cash Equivalents)	29,965,376	-	-	29,965,376
Total	$ 546,504,136	$ 35,558,036	$ 9,773,402	$ 572,288,770

June 30, 2002	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 115,258,490	$ 5,913,818	$ -	$ 121,172,308
Government Mortgage-Backed	74,848,118	1,336,638	-	76,184,756
Corporate Securities Asset-Backed	13,000,574	141,209	-	13,141,783
Other Corporate Securities	204,621,423	9,796,020	1,056,453	213,360,990
Other Securities	7,954,030	277,902	117,871	8,114,061
Equity Securities	74,000,000	-	9,819,361	64,180,639
STIP (reported as Cash & Cash Equivalents)	20,909,313	-	-	20,909,313
Total	$ 510,591,948	$ 17,465,587	$ 10,993,685	$ 517,063,850

The amortized cost and estimated market value of MSF's fixed maturity securities as of June 30, 2003 and June 30, 2002, are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2003

	Amortized Cost	**Market Value**
Due one year or less	$ 39,654,290	$ 39,841,311
Due after one year through five years	134,969,918	148,798,953
Due after five years through ten years	175,587,858	191,300,916
Due after ten years	117,292,070	122,389,437
Equity Securities	79,000,000	69,958,153
Total	$ 546,504,136	$ 572,288,770

June 30, 2002

	Amortized Cost	Market Value
Due one year or less	$ 27,914,002	$ 27,898,638
Due after one year through five years	162,357,510	171,110,658
Due after five years through ten years	131,439,950	135,976,461
Due after ten years	114,880,486	117,897,454
Equity Securities	74,000,000	64,180,639
Total	$ 510,591,948	$ 517,063,850

During fiscal year ending June 30, 2003, MSF realized gross gains from sales of securities of $3,112,888 and gross realized losses of $986,736. During fiscal year ending June 30, 2002, MSF realized gross gains from sales of securities of $6,569,675 and gross realized losses of $2,218,050.

As discussed in Note 1, GASB 31 requires governmental entities to report their investments at fair value. Fair value is defined as the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The adjustment to fair value is reflected as an increase or decrease in investment income. During fiscal year 2003, investment income for MSF was adjusted upward $19,312,732 due to the unrealized gain on long-term investments. Investment income for fiscal year 2002 was adjusted downward $2,106,803 for the unrealized loss that occurred during that year on long-term investments.

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2003 and June 30, 2002 are as follows:

		Gross Unrealized		
June 30, 2003	Amortized Cost	Gain	Loss	Market Value
Government Direct-Indirect	$ 40,202,202	$ 3,509,668	$ -	$ 43,711,870
Government Mortgage-Backed	11,699,352	335,849	5,547	12,029,654
Corporate Securities Asset-Backed	12,105	4	-	12,109
Other Corporate Securities	21,610,457	1,527,019	-	23,137,476
Other Securities	2,999,057	12,193	-	3,011,250
STIP (reported as Cash & Cash Equivalents)	4,738,975	-	-	4,738,975
Total	$ 81,262,148	$ 5,384,733	$ 5,547	$ 86,641,334

June 30, 2002	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Market Value
Government Direct-Indirect	$ 52,358,336	$ 1,489,395	$ -	$ 53,847,731
Government Mortgage-Backed	11,998,609	295,060	-	12,293,669
Corporate Securities Asset-Backed	5,441,415	113,341	-	5,554,756
Other Corporate Securities	34,595,562	891,722	651,814	34,835,470
Other Securities	2,996,807	-	176,807	2,820,000
STIP (reported as Cash & Cash Equivalents)	5,192,060	-	-	5,192,060
Total	$ 112,582,789	$ 2,789,518	$ 828,621	$ 114,543,686

The amortized cost and market value of the Old Fund fixed maturity securities as of June 30, 2003 and June 30, 2002 are shown below at contractual maturity. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2003

	Amortized Cost	Market Value
Due one year or less	$ 13,739,199	$ 13,889,831
Due after one year through five years	34,232,457	37,129,943
Due after five years through ten years	25,527,198	27,511,378
Due after ten years	7,763,294	8,110,182
Total	$ 81,262,148	$ 86,641,334

June 30, 2002

	Amortized Cost	Market Value
Due one year or less	$ 8,185,184	$ 8,204,329
Due after one year through five years	62,145,025	63,049,106
Due after five years through ten years	39,190,580	40,164,011
Due after ten years	3,062,000	3,126,240
Total	$ 112,582,789	$ 114,543,686

During the fiscal year ended June 30, 2003, the Old Fund realized $632,698 in gross gains from sales of securities and gross realized losses of $47,840. During the fiscal year ended June 30, 2002, the Old Fund realized $568,925 in gross gains from sales of securities and $85,805 in gross realized losses.

During fiscal year 2003 and 2002, the effect of GASB 31 on Old Fund investment income was an increase of $3,418,290 and $2,598,117, respectively, due to unrealized gains on its long-term portfolio.

3. Reinsurance

For the fiscal years ended June 30, 2003 and June 30, 2002, MSF ceded reinsurance to other reinsurance companies to limit the exposure arising from large losses. These arrangements consist of excess of loss contracts that protect against occurrences over stipulated amounts and an aggregate stop loss contract. The excess of loss contracts provide coverage of $95,000,000 and $112,000,000 for fiscal years 2003 and 2002, respectively. During fiscal year 2003 MSF retained the first $5,000,000 for the first layer of reinsurance coverage. During fiscal year 2002, MSF retained the first $3,000,000 with a $500,000 aggregate annual deductible for the first layer of reinsurance coverage. Individual, per person coverage was provided up to $5,000,000 per any one individual loss for both fiscal years 2003 and 2002.

The term of the current aggregate stop loss contract is July 1, 2002 through June 30, 2005. The contract provides coverage based on MSF's premium levels with maximum coverage of $21,000,000 in the aggregate or $8,600,000 per year. The previous aggregate stop loss contract was commuted prior to June 30, 2002. In the event reinsurers are unable to meet their obligations under either the excess of loss contracts or aggregate stop loss contract, MSF would remain liable for all losses, as the reinsurance agreements do not discharge MSF from its primary liability to the policyholders.

Premium revenue is reduced by premiums paid for reinsurance coverage of $5,653,833 in fiscal year 2003. The aggregate stop loss contract requires that MSF maintain a funds withheld account which represents the basic premium portion of the total premium paid for aggregate stop loss coverage. The funds withheld account at June 30, 2003 is $2,150,000 with accrued interest of $143,193, which must be accrued quarterly at an annual rate of 6.5%.

As the result of commuting the previous aggregate stop loss contract on June 30, 2002, premium revenue for fiscal year 2002 is increased by $464,760 due to the reversal of the funds withheld account which offset 2002 premiums paid for reinsurance coverage.

During fiscal years 2003 and 2002, estimated claim reserves were reduced $8,000,000 and $6,500,000 respectively, for the amount of reinsurance estimated to be ultimately recoverable on incurred losses.

MSF also has assumed reinsurance relationships with Argonaut Insurance Company, Fireman's Fund Insurance Company and Legion Insurance Company related to Other States Coverage (OSC). MSF assumes risk for OSC claims, which are then covered under MSF's ceded

reinsurance contract. Assumed premium for fiscal years 2003 and 2002 is $1,598,124 and $1,582,559, respectively.

4. Risk Management

MSF provides liability coverage to employers for injured employees that are insured under the Workers' Compensation and Occupational Disease Acts of Montana. Workers' compensation claims occurring on or after July 1, 1990, are reported in the MSF. At June 30, 2003, approximately 25,977 employers were insured by MSF. At June 30, 2002, approximately 24,961 employers were insured by MSF.

MSF is a self-supporting, competitive state fund and functions as the insurer of last resort. Workers' compensation insurance is mandatory in Montana. Employers may obtain coverage through private carriers, through MSF or through self-insurance if they meet certain criteria. Public entities may self-insure or insure through MSF. MSF serves as claim administrator on claims for injuries that occurred before July 1, 1990, known as the Old Fund. The Old Fund is considered a debt of the State of Montana and not MSF. Neither fund had significant reductions in insurance coverage from the prior year, nor any insurance settlements exceeding insurance coverage. Unpaid claims and claims adjustment expenses are estimated based on the ultimate cost of settling the claims including the effects of inflation and other social and economic factors. When MSF purchases annuity contracts, the claim is settled in full and on a final basis, and all liability of MSF is terminated.

Tillinghast-Towers Perrin, an external actuarial firm, prepares an actuarial study used to estimate liabilities and the ultimate cost of settling claims reported but not settled and claims incurred but not reported (IBNR) for MSF as of June 30, 2003 and June 30, 2002. Because actual claim costs depend on such complex factors as inflation and changes in the law, claim liabilities are recomputed periodically using a variety of actuarial and statistical techniques to produce current estimates that reflect recent settlements, claim frequency, and other economic and social factors. A provision for inflation is implicit in the calculation of estimated future claim costs because reliance is placed both on actual historical data that reflects past inflation and on other factors that are considered to be appropriate modifiers of past experience.

Tillinghast-Towers Perrin provides a range of potential costs associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2003 and 2002. The estimated claims payable is presented at face value, net of estimated reinsurance recoverable, at $413,400,000 and $346,400,000, as of June 30, 2003 and June 30, 2002, respectively. The estimated claims payable increased $67,000,000 from 2002 to 2003 primarily due to adverse loss development of approximately $36,450,000 on prior year claims. MSF currently has no knowledge of any

significant environmental or asbestos claims that would contribute to this estimate.

State law requires MSF to set premiums at least annually at a level sufficient to ensure adequate funding of the insurance program during the period the rates will be in effect. Anticipated investment income is considered when computing premium rate levels. State law also requires the MSF Board of Directors to establish surplus above risk based capital requirements to secure MSF against risks inherent in the business of insurance.

Acquisition costs represent costs associated with the acquisition of new insurance contracts or renewal of existing contracts and include agent commissions and expenses incurred in the underwriting process. MSF acquisition costs are capitalized and amortized ratably over the subsequent year. Capitalized acquisition costs at June 30, 2003 and June 30, 2002 are $1,474,338 and $878,106 respectively. For the years ended June 30, 2003 and June 30, 2002, acquisition costs that were amortized are $878,106 and $389,051 respectively.

The Old Fund covers the liability and payment of workers' compensation claims for incidents occurring before July 1, 1990. Funding for claims payments was provided by Old Fund Liability Taxes (OFLT) which are no longer in effect. The only OFLT activity that remains is miscellaneous collections and adjustments. Old Fund investment earnings must fund future claims payments.

An actuarial study prepared by Tillinghast-Towers Perrin for the Old Fund as of June 30, 2003 and June 30, 2002, is used to estimate liabilities and the ultimate cost of settling claims that have been reported, but not settled and claims that have been incurred, but not reported (IBNR). Tillinghast-Towers Perrin provides a range of potential cost associated with reported claims, the future development of those claims and IBNR. MSF management has selected the best estimate within that range as the estimated claims payable, consisting of unpaid claims and claim adjustment expenses, for fiscal years 2003 and 2002. As of June 30, 2003, the undiscounted estimated claims payable is $113,180,563 and is presented at net present value of $80,900,000 discounted at a 5.25% rate. As of June 30, 2002, the undiscounted estimated claims payable is $128,902,238 and is presented at net present value of $90,900,000 discounted at a 5.50% rate. The decrease in the discount rate from 2002 to 2003 is due to lower investment rates of return and lower investment levels from year to year.

Changes in Claims Liabilities for the Past Two Years

The following table presents changes in the aggregate liabilities for MSF and the Old Fund for the past two years net of estimated reinsurance recoverable. The information presented has not been discounted.

	MSF	
	2003	2002
Unpaid claims and claim adjustment expenses at beginning of year	$ 346,400,000	$ 325,900,000
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	116,597,841	84,369,719
Increase (decrease) in provision for events of prior years	35,366,198	5,361,281
Total incurred claims and claim adjustment expenses	151,964,039	89,731,000
Payments:		
Claims and claim adjustment expenses attributable to insured events of the current year	(22,981,961)	(16,693,000)
Claims and claim adjustment expenses attributable to insured events of prior years	(61,982,078)	(52,538,000)
Total Payment	(84,964,039)	69,231,000)
Total unpaid claims and claim adjustment expenses at end of year	$ 413,400,000	$ 346,400,000

	Old Fund	
	2003	2002
Unpaid claims and claim adjustment expenses at beginning of year	$ 128,902,238	$ 148,476,000
Incurred claims and claim adjustment expenses:		
Provision for insured events of the current year	-	-
Increase (decrease) in provision for events of prior years	(1,448,292)	(6,690,182)
Total incurred claims and claim adjustment expenses	(1,448,292)	(6,690,182)
Payments:		
Claims and claim adjustment expenses attributable to insured events of the current year	-	-
Claims and claim adjustment expenses attributable to insured events of prior years	(14,273,383)	(12,883,580)
Total Payment	(14,273,383)	(12,883,580)
Total unpaid claims and claim adjustment expenses at end of year	$ 113,180,563	$ 128,902,238

Risk Management Trend Information

The following table illustrates how the earned revenues of MSF plus investment income compare to related costs of loss and other expenses assumed by MSF for fiscal years 1994 through 2003. In addition, cumulative amounts related to estimated and actual paid claims are presented. The information allows for comparison of actual and estimated claims and is a basis for developing revenue and claims information. As data for individual policy years mature, the correlation between original estimates and re-estimated amounts is used to evaluate the accuracy of incurred claims currently recognized for less mature policy years.

Montana State Fund
(A Component Unit of the State of Montana)
Notes to Financial Statements
June 30, 2003 and 2002

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
1. Premiums and Investment Revenue										
Earned	233,699	192,548	136,432	103,780	89,010	80,594	89,213	113,226	125,437	129,608
Ceded	319	269	519	348	303	260	855	2,952	(465)	5,654
Net Earned	233,380	192,279	135,913	103,432	88,707	80,334	88,358	110,274	125,902	123,954
2. Unallocated expenses including overhead	8,637	14,772	17,839	13,006	14,831	19,472	22,718	27,555	31,020	36,484
3. Estimated losses and expenses, end of accident year										
Incurred	199,890	164,628	95,067	76,067	64,983	64,645	65,957	68,267	81,560	110,153
Ceded	-	-	-	-	-	-	-	-	-	-
Net Incurred	199,890	164,628	95,067	76,067	64,983	64,645	65,957	68,267	81,560	110,153
4. Net paid (cumulative) as of:										
End of policy year	18,693	18,137	15,818	12,589	12,943	13,723	13,177	14,140	16,693	22,982
One year later	45,947	40,473	32,890	28,451	28,222	29,976	29,218	32,888	38,185	-
Two years later	60,971	52,073	42,361	35,706	35,753	39,298	37,555	45,218	-	-
Three years later	67,576	58,722	47,283	39,860	41,004	45,748	43,649	-	-	-
Four years later	72,212	62,419	50,267	43,105	44,478	49,984	-	-	-	-
Five years later	75,799	65,919	52,791	46,478	47,584	-	-	-	-	-
Six years later	78,306	68,541	54,962	48,505	-	-	-	-	-	-
Seven years later	80,861	70,816	57,654	-	-	-	-	-	-	-
Eight years later	83,150	72,803	-	-	-	-	-	-	-	-
Nine years later	85,238	-	-	-	-	-	-	-	-	-
5. Re-estimated ceded losses and expenses	-	-	-	6,235	259	1,197	-	-	-	-
6. Re-Estimated net incurred losses and expense:										
End of policy year	199,890	164,628	95,067	76,067	64,983	63,807	65,957	68,267	81,560	110,153
One year later	184,920	124,123	88,923	67,235	64,308	64,348	66,421	71,094	86,799	-
Two years later	135,472	107,074	77,286	59,054	60,467	66,660	66,662	81,053	-	-
Three years later	116,756	95,456	73,864	60,811	61,989	69,345	70,302	-	-	-
Four years later	107,656	94,517	74,022	64,439	64,944	72,435	-	-	-	-
Five years later	105,052	92,231	73,197	59,079	67,312	-	-	-	-	-
Six years later	106,039	91,771	74,329	60,528	-	-	-	-	-	-
Seven years later	105,668	92,637	76,955	-	-	-	-	-	-	-
Eight years later	105,606	93,637	-	-	-	-	-	-	-	-
Nine years later	107,039	-	-	-	-	-	-	-	-	-
7. Increase (decrease) in estimated net incurred losses and expenses from end of policy year	(92,851)	(70,991)	(18,112)	(15,539)	2,329	7,790	4,345	12,786	5,239	0

(All dollar values are expressed in 000's.)

5. Administrative Cost Allocation

State law (Section 39-71-2352, MCA) requires MSF to separately determine and account for administrative expenses and benefit payments for claims for injuries resulting from accidents occurring before July 1, 1990 (Old Fund) from those occurring on or after July 1, 1990 (MSF). The law also limits annual administrative costs of claims associated with the Old Fund to $1,250,000. MSF allocated $1,250,000 in administration costs to the Old Fund in each of fiscal years 2003 and 2002. The Old Fund has a $1,075,781 obligation to MSF in unrecovered administrative costs incurred in fiscal years 2003 and prior. MSF intends to recover this amount in future years where the cost of administering the Old Fund is less than the statutorily permitted $1,250,000.

6. MSF Distributions

Dividends Paid to Policyholders

During the fiscal years ended June 30, 2003 and June 30, 2002, the MSF Board of Directors authorized and paid dividends to policyholders for $2,949,597 for policy year 2001 and $4,001,224 for policy year 2000, respectively.

Payments from Old Fund to MSF and State of Montana

House Bill Number 363 (HB 363), enacted by the 2003 Montana Legislature, changes existing law regulating the Old Fund transfer of surplus. HB 363 removes the 10% reserve requirement for the Old Fund and transfers the reserve as well as any remaining available funds from Old Fund to the General Fund, rather than to MSF.

The transfer amount to the General Fund in fiscal year 2003 is $22,267,907. The transfer amount to MSF in fiscal year 2002 is $7,407,512. Refer to Note 7 for additional information regarding HB 363.

7. Old Fund Net Asset Position

The State's Budget Director determined, based on the recommendation presented by the MSF Board of Directors in September 1998, that the Old Fund Liability Tax could end on January 1, 1999 in compliance with state law.

Because the Old Fund was determined to be adequately funded as of December 31, 1998, the Old Fund Liability Tax was terminated and a process was put in place to measure the status of the Old Fund's surplus level annually on a present value basis using a discount factor of 5.50% to determine compliance with state law requirements for maintaining fund adequacy.

Section 39-71-2352 (5), MCA, provided for the payment of excess funds from the Old Fund to MSF

based on adequate funding levels in the Old Fund. This law defined the term "adequately funded" to mean the present value of:

a) the total cost of future benefits remaining to be paid; and,
b) the cost of administering the claims; and,
c) an amount equal to 10% of the total of the amounts in subsections (a) and (b) above.

As of June 30, 2002, the Old Fund surplus level using a present value discount factor of 5.50% was $24,866,024. The 10% contingency required to be retained in excess of the full cost needed to cover the expense of the administration and payment of any unpaid claims equaled $9,090,000. The excess funds transferred from Old Fund to MSF were $7,407,512.

As stated in Note 6, HB 363, enacted by the 2003 Montana Legislature, changes existing law regulating the Old Fund transfer of surplus. HB 363 removes the 10% reserve requirement for the Old Fund and transfers the reserve as well as any remaining available funds from Old Fund to the General Fund, rather than to MSF. In addition, future excess funds will continue to be transferred to the General Fund.

As a result of HB 363, the calculation of excess funds to be transferred increased to $22,267,907 as of June 30, 2003. These funds were transferred to the General Fund rather than to MSF.
In order to value liabilities consistently with investments, which are expected to yield a lower rate of return due to market conditions, the estimated claims liability discount rate was decreased from 5.50% in 2002 to 5.25% in 2003. The Old Fund net asset level using a present value discount factor of 5.25% is $6,194,791 as of June 30, 2003.

8. Compensated Absences

MSF supports two leave programs, the State of Montana Leave Program and the MSF Personal Leave Program, implemented in January 2002. The State of Montana Leave Program covers all union represented employees. Union represented employees accumulate both annual leave and sick leave and MSF pays employees 100% of unused annual leave and 25% of unused sick leave upon termination. MSF also pays 100% of unused compensatory leave credits upon termination to nonexempt employees. MSF Personal Leave Program covers all non-union employees. Non-union employees accumulate personal leave and extended leave. MSF pays employees for 100% of unused personal leave upon termination but extended leave has no cash value at the time of termination.

MSF absorbs expenditures for termination pay in its annual operational costs. MSF may allocate some of these costs to Old Fund as a portion of the Old Fund administrative cost allocation. The total leave liability for MSF and Old Fund is $1,417,926 and $63,226, respectively, for fiscal year 2003. The total leave liability for MSF and Old Fund is $1,269,788 and $63,226, respectively for fiscal year 2002.

9. Retirement Plans

MSF and its employees contribute to the Public Employees Retirement System (PERS), which offers two types of retirement plans administered by the Public Employees' Retirement Board (PERB). The first plan is the Defined Benefit Retirement Plan (DBRP), a multiple-employer, cost-sharing plan that provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on eligibility, years of service and highest average compensation. Vesting occurs once membership service totals five years. Benefits are established by state law and can only be amended by the legislature.

The second plan is the Defined Contribution Retirement Plan (DCRP), created by the 1999 legislature and available to all active PERS members effective July 1, 2002. This plan is a multiple-employer, cost-sharing plan that also provides retirement, disability and death benefits to plan members and their beneficiaries. Benefits are based on the balance in the member's account, which includes the total contributions made, the length of time the funds have remained in the plan, the investment earnings less administrative costs.

Eligible PERS members choose to participate in either the DBRP or DCRP but may not be active members of both plans. MSF and its employees are required to contribute 6.9% of annual compensation in fiscal years 2003 and 2002. MSF's contributions amounted to $710,575 for fiscal year 2003 and $722,628 for fiscal year 2002. MSF and its employees paid one hundred percent of required contributions to PERS and there is no unpaid liability as of June 30, 2003.

The PERS financial information is reported in the Public Employees' Retirement Board *Comprehensive Annual Financial Report* for the fiscal year-end. It is available from PERB at 100 North Park Avenue, Suite 220, P. O. Box 200131, Helena, MT 59620-0131, 406 444-3154.

MSF and its employees are eligible to participate in the State of Montana Deferred Compensation Plan (457 plan) administered by the PERB. The Deferred Compensation plan is a voluntary, tax-deferred retirement plan designed as a supplement to other retirement plans. Under the plan, eligible employees elect to defer a portion of their salary until future time periods. MSF incurs no costs for this plan.

10. Building

The 1981 Legislature appropriated funds for the construction of a workers' compensation building. As of July 1, 1990, MSF transferred the value of the building from its records to the Department of Administration, which owns most other state buildings and charges agencies rent for their use. Under an agreement, MSF pays all costs associated with the building, including utilities, property taxes, janitorial services, and maintenance in lieu of paying rent.

11. Contingencies

Broeker v. State Fund. The issue in this case involved the way insurers calculated the social security disability offset rates on certain claims. The Workers' Compensation Court decision stated that where there is a cost of living increase built into the initial entitlement to social security disability benefits, the workers' compensation insurer cannot take the cost of living increase into consideration when computing the social security disability offset rate. There is a cost of living offset built into the initial social security entitlement in those claims where the injured worker did not apply for social security disability close to the date of injury.

On appeal, the Montana Supreme Court affirmed the Workers' Compensation Court decision. This decision appears to affect those similarly situated claimants. The case was settled and approved by the court. The settlement provides for review of certain claims and the Montana State Fund is proceeding in accordance with the terms of the settlement. The process is nearly complete. A second related case, *Buckley*, is currently filed before the Workers' Compensation Court, to address the treatment of offsets on Social Security auxiliary benefits. It is a requested common fund and it is probable it will be established as one by the court.

Murer, et al v. Montana State Compensation Mutual Insurance Fund, et al., WCC No. 9206-6487, involves the 1987 legislature's capping of workers' compensation benefits ($299.00 a week for total benefits and $149.50 a week for partial benefits) for injuries occurring during the period July 1, 1987 through June 30, 1989. The 1989 legislature reenacted those caps for the period July 1, 1989 through June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

The Montana Supreme Court found that these caps should have expired on June 30, 1989 for injuries occurring between July 1, 1987 and June 30, 1989 and should have expired on June 30, 1991 for injuries occurring between July 1, 1989 and June 30, 1991.

As a result, the Montana State Fund, under Workers' Compensation Court direction, performed a review of approximately 7500 claims. Those claims qualifying are paid 85% of the increased rate, with 15% paid to the claimant attorney. Cost impact is estimated to be over $1 million but with a cost no greater than $2 million. The cost impact has been paid or is included in Montana State Fund's loss reserves. The review and payment process is near finalization, but ongoing.

State Compensation Insurance Fund v. George Berg, et al., Case No. DV-99-34 (Fergus County), is a pending suit against a former policyholder in which the Montana State Fund claims the policyholder failed to pay workers' compensation insurance premiums, plus interest on the unpaid premiums. The total claim was originally for $1,045,954.49, but on further evaluation has been reduced to approximately $660,000. Berg filed a counterclaim against the Montana State Fund on various claims, seeking unspecified damages. Montana State Fund does not think the counterclaim has merit, but there is a remote chance of an adverse judgment against the Montana State Fund. This matter was expected to go to trial sometime

during 2001. However, Berg filed a Chapter 11 bankruptcy petition in Montana Bankruptcy Court, which stayed any further proceedings in the state court action. The Montana State Fund entered into a tentative settlement with Berg for payment of $100,000 cash, plus $125,000 payable over time. This settlement was subject to approval by the bankruptcy court in a Chapter 11 plan of reorganization. However, the bankruptcy court converted the case to a Chapter 7 liquidation. This had the effect of resurrecting the Montana State Fund's original claim amount of $660,000. The bankruptcy trustee is now liquidating Berg's bankruptcy estate. At this time, Montana State Fund is not certain how much of this claim will be recovered.

Stavenjord v. State Compensation Insurance Fund. The Stavenjord decision was issued by the Workers' Compensation Court on May 22, 2001. It addressed the issue of whether the failure of the Occupational Disease Act (ODA) to provide PPD (permanent partial disability) benefits equivalent to the benefits provided in the Montana WCA (workers' compensation act) violates the claimant's right to equal protection of the law. Relying on the Henry case (previous case from the Supreme Court finding that vocational rehabilitation benefits must also be paid under the ODA), the court said it did, holding "Where PPD benefits calculated pursuant to the WCA are greater that the benefits available to a claimant under the ODA, constitutional equal protection guarantees require that benefits be computed and paid in accordance with the WCA. The claimant in this case is entitled to $27,027 under the WCA, versus $10,000 under the ODA." The case was affirmed by the Montana Supreme Court on April 1, 2003. Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in ongoing litigation. The decision of the Workers' Compensation Court will likely be appealed to the Montana Supreme Court by at least one of the parties.

Should the ultimate decision of the Montana Supreme Court be to create a common fund and apply the decision retroactively, the cost is estimated at $15 to $20 million dollars. Should the ultimate decision of the Montana Supreme Court be to apply the decision retroactively, the impact on the Old Fund liability for claims that occurred before July 1, 1990 is estimated at $5 to $7 million. Final disposition is unknown at this time.

Rausch, Fisch and Frost. The Supreme Court decision of Rausch, Fisch and Frost addresses the payment of the impairment rating to Permanently Totally Disabled workers. The Supreme Court, in their September 5, 2002 opinion, determined the impairment is payable upon receipt of the undisputed impairment rating and not upon retirement as was the practice. In addition, the court characterized the benefit as a permanent total benefit. Attorneys' fees were awarded pursuant to the common fund doctrine. The case was remanded to the Workers' Compensation Court for further proceedings consistent with the opinion. Briefing of issues in regards to implementation of the decision occurred with the issue of applicability to claims between 1987 and 1991 pending final resolution. The Workers' Compensation Court had ruled in favor of Montana State Fund. Implementation of the common fund was settled and approved by Judge McCarter. Implementation on the agreement is ongoing. Financial impact is immaterial in that payment of the impairment ratings is a timing issue, not additional benefits.

Robert Flynn v. State Compensation Insurance Fund. The Claimant, Robert Flynn, filed a petition in the Workers' Compensation Court for the State of Montana in which he alleged that the Respondent, State Compensation Insurance Fund, should pay a proportionate share of the attorney fees he incurred to recover social security disability benefits. Flynn also requested that the Court sanction the Montana State Fund for unreasonably reducing his temporary total disability benefits in an effort to recoup overpayments. The Workers' Compensation Court denied both of Flynn's claims and Flynn appealed. The Court affirmed in part and reversed in part the judgment of the Workers' Compensation Court. (1) The Court decided that pursuant to the common fund doctrine, the Montana State Fund should contribute, in proportion to the benefits it actually received, to the costs of the litigation, including reasonable attorney fees. The Workers' Compensation Court erred when it denied Flynn's request for reasonable apportionment of attorney fees. To the extent it declined to apply the common fund doctrine, the judgment of the Workers' Compensation Court was reversed by the Supreme Court. (2) The Supreme Court agreed that nothing in the record indicated that the Montana State Fund acted unreasonably in offsetting Flynn's benefits. Therefore, the Workers' Compensation Court did not err when it concluded that the Montana State Fund was entitled to reduce Flynn's disbursements to the extent that it did to recover overpaid benefits.

The matter is currently on remand, and the Workers' Compensation Court ruled on August 5, 2003 on the issues of whether a common fund had been established and whether the decision should be applied retroactively. The court ruled for the claimant on both issues as follows, " Since claimant's entitlement to attorney fees is a matter of law and arose only after the decision on appeal, the post-remand request for attorney fees is timely." Also, "Whether the blanket rule of retroactivity of judicial decisions adopted by the United States Supreme Court in *Harper v. Virginia Dept. of Taxation*, 509 U.S. 86 (1993), or the more flexible rule from *Chevron Oil C. v. Huson*, 404 U.S. 97 (1971), is applied, the decision in *Flynn v. State Compensation Ins. Fund*, 2002 MT 279, 312 Mont. 410, 60 P.3d 397, must be applied retroactively." Settlement discussions on implementation of the common fund have been initiated. As data is not fully compiled and reviewed, no analysis of cost estimates is available at this time; however, ultimate impact is estimated at less than $1,000,000.

Schmill v. Liberty Northwest Insurance, 2003 MT 80, decided April 10, 2003 by the Montana Supreme Court held as follows, "We conclude that the ODA and the WCA treat similarly situated classes of workers differently. Furthermore, apportioning Schmill's permanent impairment award for her occupational disease pursuant to § 39-72-706, MCA, of the ODA while providing full benefits for injured workers pursuant to the WCA is not rationally related to a legitimate governmental interest. Therefore, we conclude that § 39-72-706, MCA, violates the equal protection guarantee found at Article II, Section 4 of the Montana Constitution. The judgment of the Workers' Compensation Court is affirmed." Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. The decision of the Workers' Compensation Court will likely be appealed to the Montana Supreme Court by at least one of the parties.

Should the ultimate decision of the Montana Supreme Court be to create a common fund and apply the decision retroactively, the cost is estimated at $1.5 to $2 million dollars. Should the ultimate decision of the Montana Supreme Court be to apply the decision retroactively, the impact on the Old Fund liability for claims that occurred before July 1, 1990 is estimated at $800,000. Final disposition is unknown at this time. This was not a case against the Montana State Fund, but the holding of this decision applies to Montana State Fund. Montana State Fund's motion to intervene in the case was granted by the Workers' Compensation Court. In addition a separate case against the Montana State Fund on this same issue has been filed in the Workers' Compensation Court against Montana State Fund, *Minnick*.

Wild v. Fregein and Montana State Compensation Insurance Fund, 2003 MT 115, decided April 29, 2003, primarily held that § 39-71-401(3), MCA, does not, as a matter of law, conclusively preclude any factual inquiry into whether an employer/employee relationship exists once the worker has been issued the exemption contemplated by § 39-71-401(3), MCA.", and .... "that § 39-71-401(3), MCA, read in conjunction with § 39-71-120, MCA, does require the employer to make an initial good faith inquiry of the worker to determine that he or she does, in fact, meet the control and independently established business tests before the employer employs the worker as an IC and if the employer determines the worker is an IC, to thereafter treat the worker as an IC and not as an employee as Fregein treated Wild in this case." Retroactive application of the decision and its status as a common fund is presently before the Workers' Compensation Court in on-going litigation. As data on identification of potential claims is difficult to identify, no analysis of cost estimates on retroactive application of the decision is available at this time.

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LEGISLATIVE AUDIT DIV

November 24, 2003

Scott Seacat
State of Montana
Legislative Audit Division
Room 160, Capitol Building
Helena, Montana 59620-1705

Dear Mr. Seacat:

Montana State Fund extends its appreciation to the Legislative Audit Division staff for their review of Montana State Fund's operations. Once again, we are pleased with the unqualified opinion on the financial statements for the fiscal year ending June 30, 2003, as presented in this report. We look at the results of the audit as confirmation of the financial credibility and financial strength of Montana State Fund and as a measure of commitment to serve the businesses in Montana. Our Board of Directors also appreciates the review by the Legislative Audit Division in providing them an assessment of the financial results of Montana State Fund.

Serving as Montana's guaranteed market for workers' compensation insurance, our financial stability and integrity assures that businesses have a viable option for purchasing their insurance coverage at the best possible cost to them. Our continued focus on the financial strength of our organization will allow us to best serve the Montana business community and to help foster an environment to attract and grow business in our state. With the support of the Legislature, the Governor, and our business partners, MSF will continue to lead the way in providing for the workers' compensation insurance needs for Montana businesses.

Sincerely,

Laurence A. Hubbard
President/CEO

LAH/sh